No. 12,054

IN THE

United States Court of Appeals

For the Ninth Circuit

PACIFIC PORTLAND CEMENT COMPANY, a corporation,

Appellant,

vs.

FOOD MACHINERY AND CHEMICAL CORPORATION, a corporation,

Appellee.

APPELLANT'S PETITION FOR A REHEARING.

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To the Honorable, William Denman, Chief Judge, and William E. Orr, Judge, of the United States Court of Appeals for the Ninth Circuit, and Leon R. Yankwich, Judge of the District Court of the United States for the Southern District of California:

Appellant appreciates the full consideration given by the court to this appeal and does not seek a rehearing upon the principal issue that has been resolved against it. Most earnestly, however, it does seek a rehearing on three subordinate issues for reasons which, we submit, are compelling. These issues involve the propriety of those portions of the price increases based upon (1) General and Administrative Expenses (as distinct from "plant" or

"manufacturing" overhead), (2) the charge to gypsum for New Products Research, and (3) the sulphuric acid charge.

Much of the voluminous record in this case is devoted to a consideration of the principal issue, namely, whether all overhead and indirect charges should be excluded, and we respectfully submit that in the exhaustive attention the court gave to that issue it has been overlooked that there is *no* conflict in the record as to the three subordinate issues above mentioned and *no* substantial evidence to support the decision of the trial court with respect to them.

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1. GENERAL AND ADMINISTRATIVE EXPENSES.

The amount here involved is 5 cents per ton of the second price increase and 6 cents per ton of the third (Appellant's Opening Br., pp. 50-51). Production of gypsum in the last 12-month period shown by the record was 36,658 tons (R. 565). Upon an annual production of only 30,000 tons, these amounts would equal $3300 in a year and approximately $52,800 over the 16 years from the beginning of the dispute to the end of the contract term. Further increases in which these items might figure would, of course, make these sums even larger.

We note the principle stated by the court that where resort is had to extrinsic evidence to resolve an ambiguity in a contract, the problem of interpretation presents a question of fact (Opinion, p. 17). Counsel for both parties in their briefs and the court in its opinion have cited decisions in other cases involving accounting problems.

Since the problem here presents a question of fact, such decisions are, as appellee itself has stated (Appellee's Br., p. 37), not determinative. The question of fact must be determined upon the record in this particular case.

The record establishes without conflict that only "plant" overhead or "manufacturing" overhead is included in "cost of *production,*" "cost of *production*" being distinguished from the general and all-inclusive cost of doing business. General and administrative expenses dissociated from manufacturing operations at the plant are not an element of *production* cost.

Appellee's expert, Farquhar, in answer to the carefully framed questions of appellee's counsel, testified:

> "Q. Now, Mr. Farquhar, I am going to ask you to assume that a chemical plant is recovering from a common raw material three different products, which we will designate as products A, B, and C, and I will ask you to assume that product B is technically a by-product in the sense that it consists in part of a chemical element which must be extracted from the raw material in order to produce product C in a pure and salable form. Assume also that in order to convert part of B into a salable commercial product after it is separated from the raw material, it is necessary to process it, and that for that purpose it is necessary to have a physical plant devoted exclusively to such processing, and it is likewise necessary to employ labor which devotes itself exclusively to this processing. And assume further that by reason of contract it is necessary that the manufacturer determine the cost of production of product B. Will you state, in your opinion, whether under these circumstances it is proper and good accounting practice

to include in the cost of production of product B a portion of the overhead *of the plant?**

A. If overhead is what I consider the generally accepted definition, I would say that you cannot obtain true costs of any production without some portion of the overhead, because the line of distinction between direct costs and overhead is an artificial one, largely a practical matter; that costs must include all the elements that go into it, and one of the elements that goes into the production is *the group of things that are generally classified as factory overhead.*

Q. And under the same assumed circumstances, will you state whether or not, in your opinion, it would be proper and good accounting practice to include in the cost of production of product B a portion of the *indirect charges of the plant, such as general superintendence and other charges for labor which are devoted to the production of the several products manufactured in the plant,* including product B, but as to which it is impossible or impracticable to keep records of the time devoted exclusively to each particular product.

A. Well, it is the general nature of overhead that you cannot keep a minute and accurate account of it; that you have to use some devices for allocating it, and it exists; and therefore, to get sound costs, you must absorb that overhead in the various products. And I think that, as I understand, Product B is something that, as you call it a by-product, but if it takes any further processing it must carry—it must absorb in some proportion, depending entirely on the circumstances, all the elements of cost, which would include the items which you mention." (R. 1110-1112.)

* * * * * * *

*Italics throughout this petition are supplied by us unless otherwise noted.

"Q. Will you tell us this: Whether or not in accordance with good and accepted accounting practice, it is customary to include *plant overhead* in cost of production of a manufactured product?

A. Well, you can find all stages of accounting practice in cost accounting. There has been a great deal of progress and development in it in recent years, and I think the tendency is to more and more specifically allocate all kinds of costs, either through a machine hour rate, or through a process rate which will gather together in one factor all of these various expenses. Therefore, I will say that it is—anything that tends to absorb in their actual incidence all elements of cost is good accounting practice." (R. 1115-1116.)

And on cross-examination Mr. Farquhar testified:

"Q. In that sort of situation would you assign to the cost of the by-product the *plant overhead,* a share of the entire overhead *of the plant?*

A. In so far as it can be allocated to a separate process, if separate process goes on, it immediately picks up some portion of the *plant overhead.*" (R. 1124-1125.)

* * * * * * *

"Q. Yes. Now, Mr. Farquhar, in these items that you would allocate, how far would you go? You would limit them to the actual allocation of *plant overhead,* would you not?

A. Everything that relates to the *production* of the product.

Q. *Things that don't relate to the production of the product would not be allocated to it?*

A. *Not to the production cost,* but there are other costs that follow on distribution." (R. 1130-1131.)

Mr. Farquhar would allocate administrative cost to production only where the administration deals with production (R. 1131-1132). Selling expense, for example, is not a cost of *production* (R. 1132). And finally, Mr. Farquhar testified:

> "Q. Suppose in a plant they have a certain amount of overhead that has to do with something wholly dissociated from the manufacture of a particular product that you assign as a part of the cost of the product or allocate a part of the cost of that product or portion of that particular item for overhead——
>
> A. If it is dissociated, no." (R. 1132.)

The record is clear that appellee's general and administrative expenses, to which objection is made, are general expenses of appellee's West Coast operations, dissociated from *production* expense at the Newark plant (Watt, R. 931, 1050-1053).

The testimony of appellee's expert, Maxwell, was the same as that of Farquhar:

> "Q. Mr. Maxwell, I will ask you to assume a chemical plant in which from a common raw material three different products are recovered——
>
> A. Yes.
>
> Q. ——which I will refer to as products A, B and C, and I will ask you to assume that product B is technically a by-product in the sense that it consists in part of a chemical element which must be extracted from the raw material in order to produce product C in a pure and salable form. Assume that in order to convert product B into a salable chemical product after it is separated from the raw material, it is necessary to process it, and for the purpose of

such processing it is necessary to have a physical plant devoted exclusively to such processing, and it is likewise necessary to employ labor which devotes itself exclusively to the processing of this material or this product in order to convert it into a merchantable and marketable product; and assume further that by reason of a contract it is necessary that the producer of this product B determine the cost of production or cost of manufacture of that product: Under those circumstances will you state whether or not in your opinion it is proper and good accounting practice to include in the cost of production of product B a portion of the overhead and expense *of the plant?*

A. Oh, yes, certainly; and that is the consensus of opinion of authorities." (R. 1135-1136.)

* * * * * * *

"Q. (Mr. Rosenberg.) Mr. Maxwell, under the same assumed circumstances, would it be proper and in accordance with good accounting practice to include in the cost of production of this product B a portion of the *indirect charges of the plant, such as general superintendence and other charges for labor which are devoted to the production of the several products,* including product B, but as to which it is impossible or impractical to keep records of the accurate time devoted exclusively to each particular product?

A. Yes, definitely." (R. 1136-1137.)

* * * * * * *

"Q. All of the overhead *of that plant,* the superintendence, the accounting, the various and sundry and so-called indirect items, you would allocate a portion of them to the actual cost of manufacture of these briquets, would you?

A. Yes, that portion which would be, as far as could be estimated, actually incurred with respect to briquets its fair, scientific share." (R. 1147.)

Appellee's expert, Alexander, agreed with the testimony of both Farquhar and Maxwell (R. 1187), and Alexander also testified:

"Q. I am going to ask you to assume the existence of a chemical plant which is recovering from a common raw material three different products, which I will designate as products A, B, and C, and ask you to assume that product B is technically a by-product in the sense that it consists in part of a chemical element which must be extracted from the raw material in order to produce product C in the pure and salable form, and to assume that in order to convert product B into a salable commercial product after it is separated from the raw material it is necessary to process it, and for the purpose of such processing a physical plant is required which is devoted exclusively to this processing, and labor is employed which is devoted also exclusively to the processing of the product, and I will ask you to assume further that by reason of a contract it is necessary that the manufacturer determine the cost of the production of product B, and under those circumstances will you state whether or not, in your opinion, it is proper and good accounting practice to include in the cost of production of product B a portion of the *plant overhead?*

A. Yes.

Q. And under the same assumed circumstances would it be proper and good accounting practice to include in the cost of production of product B a portion of the *indirect charges of the plant, such as general superintendence and other charges for labor*

which are devoted to the production of the several products, including product B, but as to which it is impossible or impracticable to keep records of the actual time devoted directly and exclusively to each of the particular products?

A. Yes." (R. 1175-1176.)

In regard to all of the testimony of appellee's experts, its own brief (Appellee's Br., p. 45) concedes "the fact that appellee's witnesses testified that only 'factory' or 'plant' overhead should be included * * *."

Appellant's experts also testified that in situations where overhead may be properly chargeable to a product, "cost of production" includes only *manufacturing* overhead, not general and administrative overhead (Pryor, R. 666, 691, 701; Flick, R. 262, 314).

The opinion of the court (p. 21) recognizes that there may be an element of unfairness to appellant in the matter of administration costs; but suggests appellant must accept this since it failed to anticipate and provide in the contract against charges for the administrative costs of a concern greatly expanded through a succession of mergers. We submit that the contract, interpreted in light of the clear record, *does* provide against these charges, which as we have shown are outside the category of *"production"* or *"manufacturing"* costs, to which the parties so carefully confined the contract. The contract permits price increases only when they are based upon increases in the "cost of *production* of gypsum," and expressly limits price increases to "an amount not to exceed the actual advance in California's cost of *manufacture*" (Def. Ex. G, R. 751, 754).

In its discussion of appellee's general and administrative expenses the court comments upon the method of allocating them upon a percentage basis. Appellant does not argue here the *method* of allocation—it urges that there is no substantial evidence upon which any portion of these expenses, by whatever method they might be allocated, can be included in appellee's "cost of *production*" under the contract. The contract and the record, without conflict, require exclusion of this type of expense and require appellant's protection from the element of unfairness recognized by the court.

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2. NEW PRODUCTS RESEARCH.

The amount here involved is 12 cents per ton of the second price increase and 4 cents per ton of the third (Appellant's Opening Br., pp. 50-51). Upon an annual production of 30,000 tons, these portions of these two increases alone would amount to $4800 in a year and approximately $76,800 over the contract term.

There is no dispute as to the facts regarding the charge for New Products Research. Appellant and appellee are in accord that this is the expense of research projects developing new products to be derived from the raw material, bittern (Appellee's Br., p. 41). It includes the cost of a research project seeking to eliminate gypsum as a product, as testified by appellee's manager, Wallace (R. 1093, 1094).

The record also establishes, without conflict, that as a matter of accounting principle, an item of expense

dissociated from or unrelated to the manufacture of a particular product should not be allocated to the cost of *"production"* or *"manufacture"* of that product (Farquhar, R. 1132, quoted supra pp. 5-6). Mr. Flick testified that the New Products Research charge should be eliminated because it is unrelated to gypsum manufacture (R. 292).

It is clear that New Products Research in fact has no relationship whatsoever to gypsum. Accepting the principle that a wholly unrelated expense should not be charged to a product, appellee sought, admittedly by *inference,* to show a connection between New Products Research and gypsum (Appellee's Br., p. 43), in that if new products were developed, they would bear part of the overhead and reduce the costs charged to gypsum under the contract. The court also recognized the necessity of finding a connection between this charge and the product gypsum, and accepted the suggested *inference* as supplying the link:

> "The appellee carried on research, as a part of its operations. As the production of gypsum is an integral part of a larger process of manufacture in which the appellee is engaged, any research which might result in the discovery of new products or new uses for known products, would increase the number of products among which the cost of production should be distributed. *In which event, the appellant's share would be reduced proportionately"* (Opinion, p. 21).

This inferred benefit to appellant from New Products Research is not only unsupported by any evidence; it is precluded by the contract itself under appellee's own in-

terpretation—*under paragraph (6) of the contract, price increases that once take effect are never eliminated, nor is the price appellant must pay for gypsum ever reduced when cost goes down* (Appellee's Br., p. 8; Appellant's Reply Br., pp. 17-18). In determining cost increases, costs in any given 12-month period are not compared with costs in any base period, but with costs in the immediately preceding twelve months, and the "escalator" clause works only upward, *not downward.* Unlike prices under a conventional "cost-plus" contract, the price under this contract bears no established relationship to the actual cost level at any given time. Let us assume, for example, that appellee's initial cost of production of gypsum is $1 per ton, and the price $2. If that cost rises to $1.50 per ton, a price increase of 50 cents per ton results, and the price becomes $2.50. Let us assume further that appellee through its research upon new products discovers a new major product that it begins to produce at Newark; and by distributing a portion of appellee's plant overhead to that product, appellee shows upon its books that the cost of production of gypsum has gone down to 50 cents per ton. Nevertheless, the price of gypsum to appellant *remains the same*—$2.50 per ton in the example stated. Using the words of the court, "appellant's share" is *not* reduced proportionately, or at all.

While, as the court has stated (Opinion, p. 8), it may make its own inferences from undisputed facts, and while there is no dispute in the record about any of these facts, the *inference* of a potential benefit to appellant from New Products Research is clearly inadmissible and erroneous, and results in most serious prejudice to appellant. The anomaly of charging appellant a higher price based

on the charge for New Products Research is further strikingly illustrated by the admitted fact (R. 1093, 1094) that such charge includes a research project seeking to eliminate gypsum manufacture. Not only would the court's decision require appellant to pay an increased price due to a charge that has no relationship to gypsum manufacture; it would require appellant to pay a higher price based on the cost incurred by appellee in seeking entirely to eliminate the manufacture of gypsum at the Newark plant.

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3. THE SULPHURIC ACID CHARGE.

The amount here involved is 23 cents per ton of the third price increase (Appellant's Opening Br., p. 51). Upon an annual production of 30,000 tons, this would amount to $7900 in a year and approximately $128,400 over the 16-year period in suit.

The undisputed facts as to this item are that formerly sulphuric acid served a function in the production of both bromine and gypsum. None of the sulphuric acid cost, however, was charged to gypsum. Bromine production was temporarily discontinued, and gypsum remained as the only product for which sulphuric acid was used (Appellee's Br., pp. 55-56).

It is significant that appellee's accounting experts did not testify upon the question as to the sulphuric acid charge. The court rested its decision that appellee could charge the whole cost of sulphuric acid to gypsum upon the inference that the change in assignment of this cost resulted from a change in the processes of production

(Opinion, pp. 25-26). But there was no change in the processes of manufacturing gypsum. The operating change consisted merely of an interruption of production of a separate product in another portion of the plant. Appellee's chemist Melhase testified that when bromine was being produced, the sulphuric acid remained in the bittern after the bromine process (R. 831), and appellee's office manager Watt testified that sulphuric acid has always served the same function in gypsum production, whether or not bromine is produced (R. 1015).

Appellee may suffer loss of revenue when one of its products is eliminated, and may have to absorb expenses formerly defrayed by the sale of that product. When the process of gypsum manufacture remains the same, however; when the same materials are used in producing gypsum, and in the same amounts; when the cost of those materials remains the same, it cannot be inferred that the elimination of that other product constitutes a change in gypsum manufacture, nor that any loss suffered by appellee measures an actual advance in appellee's cost of production of *gypsum*. Again, price increases, under the express language of paragraph (6) of the contract, cannot exceed "the *actual advance* in California's cost of manufacture" of gypsum.

In another and separate particular, the court was also, we submit, seriously mistaken in its decision on the sulphuric acid charge. Adverting to the fact that no part of the sulphuric acid cost was allocated to gypsum when bromine was produced, and that the whole cost was charged to gypsum when bromine was discontinued, the court said:

"So, if the whole cost is now allocated to gypsum, the appellant benefited by the omission of all charges when bromine was produced. Balance is now restored" (Opinion, pp. 25-26).

This inference of a benefit to appellant from the prior omission of the whole charge, and of a restoration of balance when the whole charge was transferred to gypsum, rests upon a fundamental misconception of the nature of the contract. If sulphuric acid were at any time to be charged to gypsum, the prior omission of the whole charge is not a benefit to appellant but imposes upon it an unwarranted penalty. The charge for sulphuric acid, first made to gypsum in the period ending June 30, 1946, was 23 cents per ton. Comparison of that period with the preceding twelve months when nothing was charged to gypsum resulted in an apparent increase due to this item in the full amount of 23 cents per ton. If, however, in the prior period all or a portion of this charge had been allocated to gypsum, the increase would have been smaller by the amount so allocated. So, if all the sulphuric acid had always been charged to gypsum, no price increase based upon this item ever would have occurred. Comparison of any one 12-month period with the preceding one would have shown two identical items of cost—23 cents—with no increase. Again, even if the 23-cent cost for sulphuric acid had been divided equally between bromine and gypsum, gypsum would have borne a sulphuric acid cost of 11½ cents per ton in the twelve months ending June 30, 1945. Comparing that twelve months with the period ending June 30, 1946, when 23 cents per ton was charged to gypsum, the increase would have been only 11½ cents

per ton, and the price of gypsum to appellant would have increased only 11½ cents, not the full 23 cents. It cannot be too strongly emphasized that if appellee had previously charged all or a portion of this cost to gypsum, this fact would not have resulted in any higher price at any earlier time under the contract, which is concerned only with *comparative* costs in any two successive 12-month periods. The presence of an element of cost which is constant has no effect upon the price.

The court's decision as to sulphuric acid is inconsistent, we submit, with its decision on the indirect shipping and compressor charges. In sustaining appellant's position on those items, the court perceived that consistency is required in the accounting methods employed in two accounting periods being compared, and stated that

> "The accounting method of the later period should have been applied to the figures of the earlier period to determine the difference, if any, of the costs in the two periods" (Opinion, p. 23).

The same principle controls the sulphuric acid charge. Assuming *arguendo* that some charge to gypsum for surphuric acid were proper, such charge should be made in *both* the accounting periods compared. The "actual advance in California's [appellee's] cost of manufacture" of gypsum, to which the contract limits any price increases, could not exceed the difference between the portion of sulphuric acid cost gypsum should formerly have borne and the later full charge for sulphuric acid.

CONCLUSION.

For the reasons above stated, we respectfully request that a rehearing be granted as to the three issues above discussed, and that this court reverse the judgment of the district court upon those issues.

Dated, San Francisco, California,
December 30, 1949.

Respectfully submitted,

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CERTIFICATE OF COUNSEL.

I hereby certify that I am one of the counsel for appellant and petitioner in the above-entitled cause and that in my judgment the foregoing petition for a rehearing is well founded in point of law as well as in fact, and that said petition for a rehearing is not interposed for delay.

Dated, San Francisco, California,
December 30, 1949.

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